China’s rate cut should help at the margin and more easing is likely

- The People’s Bank of China surprised markets by cutting interest rates and pushing ahead with interest rate liberalization by raising the deposit rate ceiling. The rate cut followed the ten measures unveiled earlier by the State Council to reduce financing costs.

- The direct impact of the rate cut on loan demand and economic growth is likely to be limited, unless it is accompanied by measures to boost liquidity, due to a weak monetary policy transmission mechanism and the need for further de-leveraging.

- Nevertheless, interest rate cuts could potentially help slow the increase in non-performing loans by lowering the corporate debt burden. In addition, interest rate cuts combined with more relaxed mortgage policies could help property demand at the margin.

- Future rate cuts will be data dependent and hinge on the trend in market lending rates. Monetary policy is likely to remain accommodative and further policy easing would limit downside growth risks and disinflationary pressures.

- Lower financing costs should provide a boost to market sentiment and is a near-term positive for Chinese equities and for both onshore and CNH bond markets. However, corporate fundamentals and effective reform implementation are key to the medium-term outlook for financial markets.

The facts

On 21 November, the People’s Bank of China (PBoC) cut the one-year benchmark deposit rate by 25bps to 2.75% and the one-year benchmark lending rate by 40bps to 5.6%. The PBoC also raised the deposit rate ceiling from 1.1 times the benchmark to 1.2 times. The net impact of lifting the deposit rate ceiling and cutting the benchmark deposit rate will be equivalent to no deposit rate cut if banks raise their deposit rates to 1.2 times base rates. We think banks are likely to price deposits at the ceiling, as there is still a significant gap between bank deposit rates and the yields offered by money market funds and wealth management products.

This was the first rate cut since July 2012. The timing and magnitude of the rate cut was surprising. However, the need to increase policy monetary easing was not, given weak growth momentum, persistent downside risks, a lacklustre property market, disinflationary pressures, and elevated real lending rates. The combination of a PBoC liquidity injection, via its open market operations and various unconventional liquidity tools, and cuts to the repo operations rate (by 40bp between July and October) have helped lower interbank market rates, bill financing rates and onshore corporate bond yields. However, despite several rounds of targeted easing, bank lending rates remained high, particularly for small businesses and mortgage lending. In real terms the cost of funding is even more elevated due to low inflation. The high lending rates partly reflect the cautious attitude of banks towards lending due to the rise in non-performing loans (NPLs) and falling bank deposits.

The PBoC said that the aim of the asymmetrical rate cuts was to both help lower financing costs for corporates and protect depositors’ interest income. It also said the rate cut was a ‘neutral’ operation, to guide market interest rates and social financing costs down to more reasonable levels, and did not represent a shift in its policy stance. The rate move was also intended to accelerate the process of interest rate reform.

Market impact

Markets responded positively to the rate cut. The Shanghai Composite index closed up 1.9%, led by gains in cyclical sectors including non-bank financials, such as real estate and brokers, industrials and materials. These three sectors posted gains of over 3%. The Hang Seng China Enterprise index rallied 3.8%. The yield on 10-year government bonds dropped 22bp to 3.45%. Government bond yields also fell in the offshore market. The 7-day repo rate fell 15bp to 3.5%. The CNY/CNH fell against the USD.

Economic impact and policy outlook

This rate cut followed the ten measures unveiled by the State Council, China’s cabinet, on 19 November to reduce financing costs. These measures include: increasing the flexibility of the loan-to-deposit ratio (LDR) requirement; simplifying debt issuance procedures for small and micro enterprises and companies in the agricultural sector; speeding up the development of private banks and other small-and-medium-sized financial institutions and encouraging lending by the internet finance industry; lowering the stock market listing threshold for small and micro enterprises and innovative/growth companies; easing cross-border financing to allow Chinese corporates to take advantage of low financing costs overseas; making better use of FX reserves to support the economy and Chinese companies’ “going global” strategy; and accelerating interest rate liberalisation, among others.
The direct impact of the rate cut on loan demand and economic growth is likely to be limited, if not accompanied by measures to boost liquidity, because China is still at an early stage of a multi-year de-leveraging process. Corporate demand for credit, especially for capital investment, has been constrained not just by high financing costs but also by sluggish business conditions, overcapacity in some industries, and elevated corporate leverage. It also remains uncertain whether, and by how much, banks will lower their lending rates given the net interest margin pressures from the asymmetrical rate cuts. The monetary policy transmission mechanism is currently weakened by the quantitative controls on banks (e.g. the reserve requirement ratio RRR and LDR), the higher risk premium demanded by banks due to corporate leverage concerns and the growth slowdown, and China’s relatively under-developed capital markets.

However, rate cuts, if they are effective in bringing down real interest rates, could potentially help slow the increase in NPLs by lowering the corporate debt burden. Rate cuts combined with more relaxed mortgage and housing policies could help property demand at the margin, particularly in tier-1 and possibly tier-2 cities. The State Council’s ten measures will take time to implement but, together with the rate cut and PBoC liquidity injection, should provide some relief to corporates. For example, a more flexible LDR requirement could help credit growth to some extent given that a significant slowdown in bank deposit growth has curtailed credit growth due to the LDR constraint. The measures to increase direct finance’s prevalence and to ease cross-border financing should also help Chinese corporates by giving them access to more channels of financing and lowering funding costs.

The rate cut has a strong market signaling effect and opens the door for further broad-based easing. Future policy direction will hinge on upcoming macro (growth, inflation, credit/ money supply and capital flows) and property-sector data and the trend in market interest rates/bank lending rates. We expect the PBoC to intensify the use of its various liquidity tools, such as the Standing Lending Facility (SLF), the Medium-term Lending Facility (MLF), Pledged Supplementary Lending (PSL), the relending facility and targeted reserve requirement ratio (RRR) cuts. Further monetary easing via interest rate cuts or a broad-based RRR cut is likely if the economy and the property market fail to at least show clear signs of stabilization, or there are large capital outflows.

We believe that the PBoC remains wary of the risk of excessive leverage/financial instability and that the government remains focused on long-term structural reforms rather than short-term growth momentum. Monetary easing may lead to an increase in corporate leverage and increased concerns over asset quality in the longer term. The compositional shift in the total social financing (TSF) statistics - towards more bank loans and bond/equity financing and away from off-balance-sheet credit, such as trust loans and banks’ acceptance bills, and interbank financing - shows that the authorities intend to support bank lending and promote alternative channels of financing, while maintaining a tight grip on shadow banking activities.

We believe the aim of the monetary policy easing is not to stimulate the economy or boost credit expansion significantly but to limit the risks of a sharp slowdown in the economy, particularly the property sector, and ease disinflationary pressures. A sharp slowdown in either economic growth or the property market would increase both NPLs and default risk and heighten the risk of financial distress.

**Investment implications**

The rate cut, particularly if it causes the market to expect an extended policy easing, could provide a boost to market sentiment and is positive for equities and for both onshore and CNH bonds in the near term. In fact, more accommodative monetary policy, via PBoC’s targeted easing measures, has been a major factor behind the good performance of Chinese financial markets over the past few months. Subdued growth momentum and inflation have also boosted the onshore bond market and the CNH market.

However, the key to a sustained period of positive market performance is that policy efforts start to bring down real lending rates and that lower financing costs eventually filter through to help improve growth momentum, corporate capex, particularly among smaller private sector businesses, and demand in the property sector. Further supportive policy efforts could include additional rate cuts or RRR cuts, targeted monetary easing, fiscal policy measures and reform measures to improve the efficiency of capital allocation and the monetary policy transmission mechanism.

In terms of the equity market, sustained lower financing costs would potentially benefit rate-sensitive sectors, such as property and materials, and brokers, which are heavily geared towards stock market performance. However, we caution that developers with a major exposure to tier-3 and tier-4 cities may continue to suffer from inventory overhang with destocking likely to last for an extended period of time. Banks’ earnings outlook will be negatively affected by the rate cuts but this could partially be offset by a perceived improvement in credit risks on the back of lower fears of a sharp growth slowdown and improved corporate debt servicing ability. Companies with relatively strong fundamentals in cyclical and/or highly-leveraged sectors, such as industrials/transportation, utilities and materials could also benefit from lower debt servicing costs and reduced downside risk to the near-term economic outlook.

Market volatility is likely to remain high, driven by the outlook for policy, growth and reform domestically and an uncertain external environment. Concerns about economic challenges and debt overhang will likely persist but more growth-supportive policies could help reduce downside risk and improve macro stability. Effective reform implementation is key to the medium-term outlook for the Chinese economy and financial markets.

Expectations of lower interest rates and concern about the possibility of policy easing via CNY depreciation – after the significant appreciation of the CNY real effective exchange rate over the past few months – could weigh on the CNY vs. the USD in the near term. However, the room for CNY depreciation is likely to be limited given that improved investor sentiment should at least limit capital outflows. We think the PBoC would not tolerate a one-way depreciation or depreciation expectations becoming entrenched.
The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance whilst any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. In Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries in which they trade. Mutual fund investments are subject to market risks, read all scheme related documents carefully.

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

HSBC Global Asset Management is the brand name for the asset management business of HSBC Group. The above communication is distributed by the following entities: in the UK by HSBC Global Asset Management (UK) Limited; in France by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026); in Germany by HSBC Global Asset Management (Deutschland) which is regulated by BaFin; in Hong Kong by HSBC Global Asset Management (Hong Kong) Limited, which is regulated by the Securities and Futures Commission; in Canada by HSBC Global Asset Management (Canada) Limited which is registered in all provinces of Canada except Prince Edward Island and is also registered in the Northwest Territories; in Cayman Islands, by HSBC Bank (Cayman) Limited, of HSBC House, 68 West Bay Road, Grand Cayman, Cayman Islands, which is licensed to conduct business by the Cayman Islands Monetary Authority (CIMA); in Malta by HSBC Global Asset Management (Malta) Limited, which is licensed to provide investment services in Malta by the Malta Financial Services Authority; in Bermuda by HSBC Global Asset Management (Bermuda) Limited, of 6 Front Street, Hamilton, Bermuda which is licensed to conduct investment business by the Bermuda Monetary Authority; in India by HSBC Asset Management (India) Pvt Ltd. which is regulated by the Securities and Exchange Board of India; in United Arab Emirates, Qatar, Bahrain, Lebanon by HSBC Bank Middle East Limited which is regulated by Jersey Financial Services Commission and relevant local Central Banks. In Oman by HSBC Bank Oman S.A.O.G Regulated by Central Bank of Oman and Capital Market Authority, Oman and in Singapore by HSBC Global Asset Management (Singapore) Limited, which is regulated by the Monetary Authority of Singapore. HSBC Global Asset Management (Singapore) Limited, or its ultimate and intermediate holding companies, subsidiaries, affiliates, clients, directors and/or staff may, at anytime, have a position in the markets referred herein, and may buy or sell securities, currencies, or any other financial instruments in such markets. HSBC Global Asset Management (Singapore) Limited is a Capital Market Services Licence Holder for Fund Management. HSBC Global Asset Management (Singapore) Limited is also an Exempt Financial Adviser and has been granted specific exemption under Regulation 36 of the Financial Advisers Regulation from complying with Sections 25 to 29, 32, 34 and 36 of the Financial Advisers Act).